6-2-2014

ROE and Leverage

Steven D. Dolvin
sdolvin@butler.edu

JMDinvestments

Monday, June 2, 2014

ROE and Leverage

Return on equity (ROE) can be decomposed into three pieces, the so-called DuPont Identity: Net profit margin, total asset turnover, and the equity multiplier. The equity multiplier is a measure of leverage, so firms that add financial leverage (i.e., debt) to their balance sheet can increase ROE, as long as the product of the other two factors (i.e., return on assets) is positive. In the standard growth model for pricing stocks, this would generally have a positive impact on stock price, but note that it does add risk to the potential outcome, i.e., leverage. See article here, The Economist.

Related Chapters: Chapter 06